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1. FINANCIAL STATEMENT PRESENTATION

A. *Introduction*

The accompanying combined financial statements (Statutory Basis Financial Report) of the Commonwealth of Massachusetts (the Commonwealth) are presented in accordance with the requirements of Section 12 of Chapter 7A as amended by Section 4 of Chapter 88 of the Acts of 1997 of the Massachusetts General Laws. The Office of the Comptroller also publishes the Commonwealth's Comprehensive Annual Financial Report (CAFR) which is prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for governments. GAAP is prescribed by the Governmental Accounting Standards Board (GASB), the authoritative standard-setting body for establishing governmental accounting and financial reporting principles.

The Statutory Basis Financial Report (SBFR) includes all the budgeted and non-budgeted funds and account groups of the Commonwealth, as recorded by the Office of the Comptroller in compliance with Massachusetts General Laws and in accordance with the Commonwealth's budgetary principles.

The Statutory Basis Financial Report's Financial Statements are not intended to include independent authorities, non-appropriated funds of higher education or other organizations included in the Commonwealth's reporting entity as it would be defined under GAAP.

B. *Statutory Basis*

The Commonwealth reports its statutory basis financial position and results of operations in funds and account groups, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund balances, revenues and expenditures/expenses. Transactions between funds within a fund type, if any, have not been eliminated.

Account groups are accounting entities used to provide accountability for the Commonwealth's general fixed assets and long-term obligations. They are not considered funds because they do not report expendable available financial resources and related liabilities.

C. *Governmental Fund Types*

The Fund types and account groups are organized as follows:

Governmental Fund Types account for the general governmental activities of the Commonwealth.

Budgeted Funds – are the primary operating funds of the Commonwealth. They account for all budgeted governmental transactions. Major budgeted funds include the General and Highway funds which are identified by the Comptroller as the operating funds of the Commonwealth.

Non-Budgeted Special Revenue Funds – are established by law to account for specific revenue sources that have been segregated from the budgeted funds to support specific governmental activities such as federal grants, funds related to the tobacco settlement and the operations of the state lottery.

Capital Projects Funds – account for financial resources used to acquire or construct major capital assets and to finance local capital projects. These resources are derived from proceeds of bonds and other obligations, which are generally received after related expenditures have been incurred, operating transfers authorized by the Legislature and from federal reimbursements. Deficit balances in Capital Projects Funds represent amounts to be financed.

D. *Fiduciary Fund Types*

Fiduciary Funds account for assets held by the Commonwealth in a trustee capacity (Trust Funds), or as an agent (Agency Funds) for individuals, private organizations, other governmental units, and/or other funds.

Expendable Trust Funds – account for trusts whose principal and investment income may be expended for a designated purpose.

Nonexpendable Trust Funds – account for trusts whose principal cannot be spent.

Pension Trust Funds – account for the net assets available for plan benefits held in trust for the State Employees' and Teachers' Retirement Systems.

Agency Funds – account for assets the Commonwealth holds on behalf of others. Agency Funds are custodial in nature and do not involve measurement of operations.

E. *Account Groups*

Account Groups establish control and accountability over the Commonwealth's general fixed assets and long-term obligations.

General Fixed Assets Account Group – accounts for the general fixed assets of the Commonwealth and capital leases.

General Long-term Obligations Account Group – accounts for long-term bonds and notes issued by the Commonwealth and capital leases.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. *Statutory Basis of Accounting*

The SBFR is prepared from the Commonwealth's books and records and other official reports which are maintained on the basis of accounting used in the preparation of the Commonwealth's legally adopted annual budget (statutory basis). The statutory basis emphasizes accountability and budgetary control of appropriations. The SBFR is not intended to present the Commonwealth's financial condition and results of operations in conformity with GAAP. Under GAAP, the books are accounted for using a current financial resources measurement focus and the modified accrual basis of accounting.

Under the statutory basis of accounting, revenues are generally recognized when cash deposits are received by the Treasury. However, revenues receivable for federal grants and reimbursements are recognized when related expenditures are incurred. Amounts due from political subdivisions of the Commonwealth are recognized when considered measurable and available. Deeds excise taxes are recognized at the time of collection by the counties and the Commonwealth.

Under the statutory basis of accounting, expenditures are generally recorded when the related cash disbursement occurs. At year-end, payroll is accrued and payables are recognized, to the extent of approved encumbrances, for goods or services received by June 30. Costs incurred under the federally-sponsored Medicaid program, amounts required to settle claims and judgments against the Commonwealth, and certain other liabilities are not recognized until they are encumbered or otherwise processed for payment. Under GAAP, expenditures are recorded in the period in which the related fund liability is incurred.

The Pension Trust Funds are reported using a flow of economic resources measurement focus and the accrual basis of accounting on both the statutory and GAAP basis. Under this method, additions are recorded when earned and deductions are recorded at the time liabilities are incurred. This measurement focus emphasizes the determination of net change in assets available for pension benefits.

The accounting policies followed in preparing the accompanying statutory basis financial report are described in the remainder of this section.

B. *Cash, Short-term Investments and Investments*

The Commonwealth follows the practice of pooling the cash and cash equivalents of its Governmental and Fiduciary Funds. Cash equivalents consist of short-term investments with an original maturity of three months or less and are stated at cost. Interest earned on pooled cash is allocated to the General Fund, Expendable Trust Funds and, when so directed by law, to certain Special Revenue and Capital Projects Funds.

The Pension Trust Funds, with investments of approximately $29,797,126,000 at fair value, are permitted to make investments in equity securities, fixed income securities, real estate, timber and other alternative investments. For investments traded in an active market, the fair value of the investment will be its market price. The Pension Trust Funds include investments in real estate, venture capital funds, real estate funds, limited partnerships, futures pools, international hedge pools, commodities pools, balanced pools, leveraged buyouts, private placements and other alternative investments. The structure, risk profile, return potential and marketability differ from traditional equity and fixed income investments. Concentration of credit risk exists if a number of companies in which the fund has invested are engaged in similar activities and have similar economic characteristics that could cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. To mitigate the exposure to concentrations of risk, the Pension Trust Funds invest in a variety of industries located in diverse geographic areas. As of June 30, 2004, the estimated fair values, determined by management with input from the investment managers, of these real estate and alternative investments were $5,496,796,000 of the Pension Trust Funds, representing 15.1% of the total assets of the Fiduciary Fund Type.

C. *Securities Lending Program*

The Pension Trust Funds participate in securities lending programs. Under these programs, the Trusts receive a fee for allowing brokerage firms to borrow certain securities for a predetermined period of time, securing such loans with cash or collateral typically equaling 102% to 105% of the fair value of the security borrowed. The collateral securities cannot be pledged or sold by the Pension Reserve Investment Trust (PRIT) unless the lending agents default. The lending agents are required to indemnify PRIT in the event that they fail to return the securities on loan (and if the collateral is inadequate to replace the securities on loan) or if the lending agents fail to perform their obligations as stipulated in the agreements. There were no losses resulting from default of the lending agents during the years ending June 30, 2004 and 2003. At June 30, 2004, the fair value of the securities on loan from PRIT was approximately $2,115,720,000. The fair value of the collateral held by PRIT amounted to $2,204,156,000 at June 30, 2004, of which $943,000,000 was cash.

D. *Receivables*

Receivables are stated net of estimated allowances for uncollectible accounts. Reimbursements due to the Commonwealth for its expenditures on federally funded reimbursement and grant programs are reported as "Due from federal government."

E. *Due from Cities and Towns*

Represents reimbursement due to the Commonwealth for its expenditures on certain programs for the benefit of cities and towns.

F. *Dedicated Revenue*

The Commonwealth has various streams of dedicated revenues reflected in non-budgeted fund activity. Approximately $2.0 billion in revenues from federal grants passed through the Federal Grants Fund represents the greatest source of dedicated revenues. The largest pledge of tax revenues apportions a "dedicated sales tax" amounting to 1% of applicable sales in the Commonwealth directly to the Massachusetts Bay Transportation Authority (MBTA). Total dedicated sales tax revenue directed to the MBTA in FY04 was approximately $684,281,000. Other major dedicated tax revenue streams include surcharges from areas contiguous to convention centers to support such centers' operations, motor fuels taxes to support highway construction, repairs and maintenance and cigarette taxation to support health and human service costs. In FY05 additional dedicated sales tax revenue will be pledged to fund school construction via a transfer to the Massachusetts School Building Authority.

G. *Inventories*

The costs of materials and supplies are recorded as expenditures in Governmental Funds when purchased. Such inventories are not material in total to the financial statements and therefore are not presented.

H. *General Fixed Assets*

General fixed asset acquisitions are recorded as expenditures in the acquiring fund and capitalized in the General Fixed Assets Account Group in the year purchased. General fixed assets are recorded at historical cost, or at estimated historical cost if actual historical cost is not available. Donated fixed assets are recorded at estimated fair market value at the date of donation.

The cost of normal maintenance and repairs that do not add to the value of the assets or materially extend asset lives are not capitalized. Improvements are capitalized.

The Commonwealth capitalizes all land except land associated with infrastructure. It capitalizes buildings and equipment, including computer software, with a cost in excess of $100,000 and $50,000 respectively at the date of acquisition and with an expected useful life greater than one year. Public domain general fixed assets and infrastructure (roads, bridges, tunnels, dams, water and sewer systems, etc.) are not capitalized. Interest incurred during construction is not material and is not capitalized. Under the statutory basis of accounting, no depreciation is taken on general fixed assets.

I. *Interfund / Intrafund Transactions*

During the course of its operations, the Commonwealth records transactions between funds and / or between departments. On the statutory basis, transactions between Governmental and Fiduciary Fund Types are recorded as adjustments to the funds' cash accounts. As a result, a fund may report a deficiency in cash and short-term investments.

Transactions of a buyer/seller nature between departments within a fund are not eliminated.

Transfers in and out net to approximately $4,259,000 due to higher education non-appropriated fund activity, which is not included in the combined statements – statutory basis.

J. *Risk Management*

The Commonwealth does not insure for state employees workers' compensation, casualty, theft, tort claims and other losses. Such liabilities are not recognized on the statutory basis until encumbered and / or processed for payment. For employees workers' compensation, the Commonwealth assumes the full risk of claims filed under a program managed by the Human Resources Division. For personal injury or property damages, Chapter 258 of the Massachusetts General Laws (General Laws) limits the risk assumed by the Commonwealth to $100,000 per occurrence, in most circumstances. The Group Insurance Commission administers contributory health care and other insurance programs for the Commonwealth's employees and retirees.

The Commonwealth has entered into agreements for insurance for Central Artery/Tunnel Project workers' compensation and certain general liability claims that may arise in the course of the Project. This special arrangement has been approved by the Federal Highway Administration as a cost-effective method to fund current and potential future claims by contractors, workers, and other parties affected by the project. Pursuant to the agreement, the Commonwealth conveys a sum of money to an agent each month. This amount includes both federal and state share. The agent manages and settles all claims. At the conclusion of the program, the balance remaining, if any, will be returned to the Commonwealth. The monthly amount conveyed to an agent is accounted for (on the statutory basis of accounting) as an expenditure in the Federal Highway Capital Projects Fund.

K. *Encumbrances*

Encumbrance accounting is utilized in the Governmental Fund Types as a significant aspect of budgetary control. The full amounts of purchase orders, contracts and other commitments of appropriated resources are encumbered and recorded as deductions from appropriations prior to actual expenditure, ensuring that such commitments do not exceed appropriations. Encumbrances outstanding at year-end for goods or services received on or before June 30 are reported as expenditures and statutory basis liabilities as a component of accounts payable.

L. *Fringe Benefit Cost Recovery*

The Commonwealth appropriates and pays the fringe benefit costs of its employees and retirees through the General Fund. These fringe benefits include the costs of employees' health insurance, pensions, unemployment compensation, and other costs necessary to support the state work force. As directed by Chapter 29, Sections 5D and 6B(f) of the Massachusetts General Laws, these costs are assessed to other funds based on their payroll costs, net of credits for direct payments. Since these fringe benefit costs are not appropriated in the budget, the required assessment creates a variance between budget and actual expenditures at year-end. The fringe benefit cost recoveries of $177,646,000 in the budgeted funds result from costs assessments of $120,116,000 in the governmental fund types and the expendable trust funds. The remainder of $57,530,000 is assessed to the higher education non-appropriated activity, which is not included in the statutory basis financial report.

M. *Lottery Revenue and Prizes*

Ticket revenues are recognized when sold and prizes awarded by the Massachusetts Lottery Commission are recognized as drawings are held.

N. *Fund Balances*

The Commonwealth reports fund balances as reserved where legally restricted for a specific future use. Otherwise, these balances are considered unreserved.

Fund balance has been reserved as follows:

"Reserved for continuing appropriations" – are unexpended amounts in appropriations, which the Legislature has specifically authorized to be carried into the next FY.

"Reserved for Commonwealth stabilization" – are amounts set aside in the Commonwealth Stabilization Fund in accordance with 5C of Chapter 29 of the Massachusetts General Laws.

"Reserved for debt service" – are amounts held by fiscal agents or the Commonwealth to fund future debt service obligations.

"Reserved for employees' pension benefits" – are the net assets of the Commonwealth's public employee retirement systems which cannot be used for any other purpose.

"Reserved for unemployment benefits" – are amounts reserved for payment of unemployment compensation.

"Reserved for capital projects" - are amounts reserved for capital projects.

Unreserved fund balance is segregated into two components:

"Designated for specific purpose" – are all unreserved fund balances for which the Legislature or Executive Branch has evidenced an intention to restrict for a specific purpose.

"Undesignated" – consists of cumulative surpluses or deficits of the Governmental Fund Types not otherwise designated.

O. *Reclassification*

Certain reclassifications have been made to the FY03 account balances to conform to the presentation used in FY04. Due to departmental mergers and transfers among secretariats, certain functions of government may not be entirely comparable to FY03. FY03 balances were not reclassified to reflect these changes in law because doing so would be inconsistent with FY03 statutes. These changes primarily affected Consumer Affairs, Labor and Health and Human Services.

3. BUDGETARY CONTROL

State finance law requires that a balanced budget be approved by the Governor and the Legislature. The Governor presents an annual budget to the Legislature, which includes estimates of revenues and other financing sources and recommended expenditures and other financing uses. The Legislature, which has full authority to amend the budget, adopts an expenditure budget by appropriating monies at the individual appropriation account level in an annual appropriations act.

Before signing the appropriations act, the Governor may veto or reduce any specific item, subject to legislative override. Further changes to the budget established in the annual appropriations act may be made via supplemental appropriation acts or other legislative acts. These must also be signed by the Governor and are subject to the line item veto.

In addition, Massachusetts General Laws authorize the Secretary of Administration and Finance, with the approval of the Governor, upon determination that available revenues will be insufficient to meet authorized expenditures, to withhold allotments of appropriated funds which effectively reduce the account's expenditure budget.

The majority of the Commonwealth's appropriations are non-continuing accounts which lapse at the end of each fiscal year. Others are continuing accounts for which the Legislature has authorized that an unspent balance from the prior year be carried forward and made available for spending in the current fiscal year. In addition, the Legislature may direct that certain revenues be retained and made available for spending within an appropriation. Fringe benefits and other costs which are mandated by state finance law are not itemized in the appropriation process and are not separately budgeted.

Because revenue budgets are not updated subsequent to the original appropriation act, the comparison of the initial revenue budget to the subsequent, and often modified, expenditure budget can be misleading. Also, these financial statements portray fund accounting with gross inflows and outflows, thus creating a discrepancy to separately published budget documents. In conducting the budget process, the Commonwealth excludes those interfund transactions that by their nature have no impact on the combined fund balance of the budgeted funds.

Generally, expenditures may not exceed the level of spending authorized for an appropriation account. However, the Commonwealth is statutorily required to pay debt service, regardless of whether such amounts are appropriated.

The FY04 General Appropriation Act (Chapter 26, Section 167 of the Acts of 2003), amended section 9C, directing the Governor to notify the Legislature in writing as to the reasons for and the effect of any reductions. Alternatively, the Governor may propose specific additional revenues to equal the deficiency. The Governor may also propose to transfer funds from the Stabilization Fund to cure such deficiency. This proposal must be delivered to the Legislature 15 days before any reductions take effect.

The following table summarizes budgetary activity for FY04 (amounts in thousands):

	Revenues	Expenditures
General Appropriation Act, Chapter 26 of the Acts of 2003:		
Direct appropriations	$ 20,811,293	$ 20,685,549
Estimated revenues, transfers, direct appropriations retained revenue appropriations, interagency chargebacks and appropriations carried forward from FY2003	1,192,798	1,192,798
Total Original Budget	22,004,092	21,878,347
Supplemental Acts of 2003:		
Chapter 101	-	1,619
Chapter 118	-	22,161
Chapter 140	-	110,393
Chapter 141	-	20,750
Supplemental Acts of 2004:		
Chapter 40	-	52,188
Chapter 65	-	64,076
Chapter 304	-	11,529
Total Before June 30, 2004	22,004,092	22,161,063
Supplemental Acts of 2004, passed after June 30, but for FY04:		
Chapter 352	-	389,133
Total Budgeted Revenues and Expenditures per Legislative Action	22,004,092	22,550,196
Plus: Transfers of Revenues and Expenditures (including rounding)	511,643	1,905,490
Budgeted Revenues and Expenditures as Reported	$ 22,515,735	$ 24,455,686

The following table identifies the interfund activity from budgeted sources and uses to reconcile forecasts prepared during the budget process to the results presented in these statements: (amounts in thousands)

	Revenues and Other Financing Sources	Expenditures and Other Financing Uses
Actual as presented in the combined budget and actual statement - statutory basis	$ 26,046,983	$ 24,906,963
Adjustments to revenues and expenditures		
Transfer to the Intragovernmental Service Fund Revenues	(133,707)	(133,707)
Adjustments to other financing sources and uses:		
Fringe benefit cost assessments	(46,262)	(46,262)
Year-end Stabilization Transfer	(663,457)	(663,457)
Transfer from the Intragovernmental Service Fund to the General Fund	(550)	(550)
RMV License Plates	(2,374)	(2,374)
Stabilization transfers to the General Fund	(115,815)	(115,815)
Excess Permissable Tax Revenue Transfer from General Fund to Temporary Holding Fund	(357,403)	(357,403)
Year-End Excess Permissable Tax Revenue Transfer from Temporary Holding Fund to Stabilization Fund	(357,465)	(357,465)
Transfers from Stabilization Fund per Chapter 352	(381,433)	(381,433)
Other	(171)	(171)
Actual as presented on budgetary documents	$ 23,988,346	$ 22,848,326

The section divider for the budgeted funds contains a list of budgeted funds grouped by categories.

The Office of the Comptroller has the responsibility to ensure that budgetary control is maintained on an individual appropriation account basis. Budgetary control is exercised through the state accounting system, Massachusetts Management Accounting and Reporting System (MMARS). Encumbrances and expenditures are not allowed to exceed the appropriation account's spending authorization.

Also as part of the FY04 General Appropriation Act, the Legislature redefined consolidated net surplus to include all budgeted funds. Along with this action, the Legislature closed 51 budgeted, capital projects and trust funds. All of the future activity in these funds will be reported in the General Fund. Several other minor funds were also moved from budgeted funds to non-budgeted funds or trust funds.

The FY02 General Appropriation Act adjusted the calculation of permissible tax revenues under Massachusetts General Laws Chapter 62F. Effective on July 1, 2003, the Commissioner of Revenue calculated the difference between cumulative net state tax revenues and cumulative permissible tax revenues on a quarterly basis instead of on an annual basis. For any quarter in which cumulative net state tax revenues exceed permissible tax revenues as certified by the Commissioner of Revenue, the Comptroller transfers this excess from the General Fund to the Temporary Holding Fund contained within the Stabilization Fund. The FY04 General Appropriation Act amended this language to say that in any year when the Stabilization Fund is required to pay current expenses of the Commonwealth, any balance within the Temporary Holding Fund contained within the Stabilization Fund reimburses the Stabilization Fund. Any funds remaining in the temporary holding fund at the end of the fiscal year are to be transferred to the General Fund and included as part of the calculation of consolidated net surplus.

4. DEPOSITS AND INVESTMENTS

The Commonwealth maintains a cash and short-term investment pool that is available for use by all funds. Each fund type's net equity in this pool is displayed on the combined balance sheet as either "Cash and short-term investments" or "Deficiency in cash and short-term investments." The investments of the Pension Trust Funds are held in a separate trust.

The Office of the Treasurer and Receiver-General (Treasury) manages the Commonwealth's short-term investment pool. Statutes authorize investment in obligations of the U.S. Treasury, authorized bonds of all states, banker's acceptances, certificates of deposit, commercial paper rated within the three highest classifications established by Standard & Poor's Corporation and Moody's Commercial Paper Record and repurchase agreements that any of these obligations secure. Such investments are carried at cost, which approximates fair value.

Pooled cash and short-term investments include the following (amounts in thousands):

Cash and short-term investments.............................	$ 7,212,367
Cash with fiscal agent...	761,285
Cash on Deposit with U. S. Treasury.........................	122,449
Deficiency in cash and short-term investments........	(1,461,004)
Total...	$ 6,635,097

Other investments, mainly in escrows, the Pension Trust Funds and the Health Care Security Trust Fund (HST) are reported at fair value in the financial statements. The investments of the Pension Trust Funds are held separately from those of other Commonwealth funds, with the exception of their investments in the Massachusetts Municipal Depository Trust (MMDT). The Pension Trust Funds and the HST are permitted to make investments in equity securities, fixed income securities, real estate and other alternative investments. In the following table these alternative investments, venture capital and futures pools are classified as other investments.

Investments are classified as to collateral risk into the following three categories:

Category 1: Insured or registered, or securities held by the Commonwealth or its agent in the Commonwealth's name.

Category 2: Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the Commonwealth's name.

Category 3: Uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the Commonwealth's name.

The following table presents a combined view of investments, followed by tables separating the Pension Trust Fund investments and the HST investments from this combined view. (Amounts are in thousands).

Investment	Market Value CATEGORY 1	CATEGORY 2	CATEGORY 3	Total
Repurchase agreements	$ 219	$ -	$ -	$ 219
Government obligations	2,377,261	-	-	2,377,261
Equity securities	16,103,952	-	-	16,103,952
Fixed income securities	4,543,246	-	-	4,543,246
Other	7,459	-	-	7,459
	$ 23,032,137	$ -	$ -	23,032,137
Money market investments				404,196
Money market related accounts				5,397,054
Real estate				2,664,604
Assets held in trust				2,981,982
Cash on deposit with U. S. Treasury				122,449
Certificates of deposit				272,301
Other				4,475,171
Total				$39,349,894

The Pension Trust Funds have invested a significant portion of their portfolios into a trust, which pools assets for investment purposes and allocates returns on these investments in proportion to each fund's share of the pool. The fund includes money held on behalf of other governments.

The investments are carried at fair value. At June 30, 2004, they are as follows (amounts in thousands):

Investment	Market Value CATEGORY 1	CATEGORY 2	CATEGORY 3	Total
Government obligations	$ 2,346,849	$ -	$ -	$ 2,346,849
Equity securities	15,871,564	-	-	15,871,564
Fixed income securities	4,456,835	-	-	4,456,835
	$ 22,675,248	$ -	$ -	22,675,248
Money market related accounts				1,826,707
Real estate				2,648,651
Other				4,473,226
Total				$ 31,623,832

On behalf of the HST, the Pension Reserve Management Board has invested a significant portion of their portfolio into a trust, which pools assets for investment purposes and allocates returns on these investments in proportion to the fund's share of the pool.

The investments are carried at fair value. At June 30, 2004, they are as follows (amounts in thousands):

Investment	Market Value CATEGORY 1	CATEGORY 2	CATEGORY 3	Total
Government obligations	$ 30,412	$ -	$ -	$ 30,412
Equity securities	232,388	-	-	232,388
Fixed income securities	86,411	-	-	86,411
Other	7,459	-	-	7,459
	$ 356,670	$ -	$ -	356,670
Money market related accounts				88,616
Real estate				15,953
Other				1,945
Total				$ 463,184

Of the investments, $75,146,281 in the Health Care Security Trust Fund represents amounts owed to the General Fund. On July 1, 2004, $43,917,971 of these accrued redemptions were transferred to the General Fund in accordance with Massachusetts General Laws Chapter 29D, Section 3(f), representing 50% of the total return generated by the Account for the period October 1, 2002 through September 30, 2003. Said Chapter 29D, Section 3(f) was recently amended by Section 14 of Chapter 352 of the Acts of 2004. The period upon which the total return calculation is based changed to the 12-month period ending June 30. As a result of this amendment, the fund includes an additional $31,228,310 owed to the General Fund representing 50% of the amount of earnings of the investments for the nine-month period beginning October 1, 2003 and ending June 30, 2004 to be paid on July 1, 2005. Total return represents net investment income less administrative fees.

A. *Financial Instruments with Off-Balance Sheet Risk*

Certain investments of the Commonwealth may involve a degree of risk not accounted for on the respective financial statements. A description of such “off-balance sheet risks” are as follows:

Forward Currency Contracts

The Pension Trust Funds enter into forward currency contracts to hedge the exposure to changes in foreign currency exchange rates on foreign portfolio holdings. The market value of the contract will fluctuate with changes in currency exchange rates. Risks may arise upon entering these contracts from the potential inability of counterparties to meet the terms of their contracts and from unanticipated movements in the value of a foreign currency relative to the U.S. dollar.

When the contract is closed, the Pension Trust Funds record a realized gain or loss equal to the difference between the value of the contract at the time it was opened and the value at the time it was closed. Fluctuations in the value of forward currency contracts are recorded as unrealized gains or losses by the Pension Trust Funds.

Futures Contracts

The Pension Trust Funds may purchase and sell financial futures contracts to hedge against changes in the values of securities the fund owns or expects to purchase. Upon entering such contracts, they must pledge to the broker an amount of cash or securities equal to a percentage of the contract amount.

The potential risk is that the change in the value of futures contracts primarily corresponds with the value of underlying instruments, which may correspond to the change in value of the hedged instruments. In addition, there is a risk that PRIT may not be able to close out its future positions due to a non-liquid secondary market. Risks may arise from the potential inability of a counter-party to meet the terms of a contract and from unanticipated movements in the value of a foreign currency relative to the U.S. dollar. The Pension Trust Funds may also invest in financial futures contracts for non-hedging purposes.

Payments are made or received by the Pension Trust Funds each day, depending on the daily fluctuations in the value of the underlying security and are recorded as unrealized gains or losses. When the contracts are closed, the Pension Trust Funds recognize a realized gain or loss.

Options

PRIT is also engaged in selling or "writing" options. The Pension Trust Funds, as writers of options, may have no control over whether the underlying securities may be sold (call) or purchased (put) and, as a result, bear the market risk of an unfavorable change in the price of the security underlying the written option. As of June 30, 2004, there were no material options outstanding.

5. SHORT-TERM FINANCING AND CREDIT AGREEMENTS

Massachusetts General Laws authorize the Treasurer to issue temporary notes in anticipation of revenue or bond financing. When this short-term debt does not meet long-term financing criteria, it is classified as a fund liability. Short-term debt may be issued on either a stand-alone basis or through a commercial paper program maintained by the Commonwealth.

A. *General Fund*

The balance of revenue anticipation notes (RANs) outstanding may fluctuate during a fiscal year, but must be reduced to zero at June 30. During FY04, the Commonwealth issued RANs through its commercial paper program on a periodic basis to meet cash flow needs. A maximum of $450,000,000 of RANs were outstanding at any time during the year. All RANs were retired before the end of June 2004.

B. *Capital Project Funds*

The Commonwealth may issue bond anticipation notes (BANs) to temporarily finance its capital projects. BANs may be issued either on a stand-alone basis or through the Commonwealth's commercial paper program.

Beginning in FY03 and continuing through FY04, the Commonwealth periodically issued BANs through the commercial paper program. BANs were rolled over and paid down at various times during the fiscal year. No more than $650,100,000 of BANs were outstanding under the commercial paper program at any time during FY04. At June 30, 2004, BANs totaling $75,100,000 remain outstanding.

On March 28, 2002, $180,000,000 in General Obligation BANs were also issued to finance costs of the Central Artery / Tunnel Project, in advance of receiving certain contributions from the Massachusetts Port Authority (Massport). These BANs were retired in April, 2003 through the issuance of commercial paper. During June 2003, Massport delivered to the Commonwealth $104,900,000 pursuant to Section 12 of Chapter 81A of the General Laws and the Roadway Transfer Agreement dated as of March 23, 1999, as amended (the "Transfer Agreement") among Massport, the Commonwealth, acting by and through the Massachusetts Highway Department, and the Massachusetts Turnpike Authority. This payment of $104,900,000 was applied to retire a portion of the commercial paper BANs. $75,100,000 of such BANs remains outstanding as of June 30, 2004.

On December 31, 2003, Massport was expected to make an additional payment to the Commonwealth under the Transfer Agreement of $50,000,000, which would have been applied against these BANs. However, under the terms of the Transfer Agreement, the final two payments of $50,000,000 each are due on December 31, 2003 and 2004, respectively, only to the extent that Massport has received assets of commensurate value. Prior to December 31, 2003, Massport informed the Commonwealth that such assets had not been received and that Massport therefore withhold the final two payments until such assets were transferred.

C. *Line-of-Credit Facilities*

During FY04, the Commonwealth maintained line-of-credit facilities to provide liquidity support for commercial paper notes totaling $1,000,000,000. The Commonwealth has a total of five line-of-credit facilities to provide such liquidity support, each in the amount of $200,000,000. These facilities expire in periods from December 2004, through December 2006 at various times. The annual cost of these facilities ranges from 0.125% to 0.17%.

The following schedule details short – term financing and credit agreement activity, net, for all funds for the fiscal year (amounts in thousands):

	Beginning Balance July 1, 2003	Issued / Drawn	Redeemed / Repaid	Ending Balance June 30, 2004	Credit Limit June 30, 2004
General Fund:					
Revenue anticipation notes..................................	$ -	$ 450,000	$ (450,000)	$ -	$ -
Line-of-credit agreements....................................	-	-	-	-	1,000,000
.					
Subtotal - General Fund activity.....................	-	450,000	(450,000)	-	1,000,000
Capital Projects Funds:					
Bond anticipation notes.......................................	857,100	575,000	(1,357,000)	75,100	-
Subtotal - Capital Projects Funds activity........	857,100	575,000	(1,357,000)	75,100	-
Total short-term financing and credit agreement activity.......................	$ 857,100	$ 1,025,000	$ (1,807,000)	$ 75,100	$ 1,000,000

6. LONG-TERM DEBT

Under the Constitution of the Commonwealth of Massachusetts, the Commonwealth may borrow money (a) for defense, (b) in anticipation of receipts from taxes or other sources, any such loan to be paid out of the revenue of the year in which the loan is made, or (c) by a two-thirds vote of the members of each house of the Legislature present and voting thereon. The Constitution further provides that borrowed money shall not be expended for any other purpose than that for which it was borrowed or for the reduction or discharge of the principal of the loan. In addition, the Commonwealth may give, loan or pledge its credit to another entity by a two-thirds vote of the members of each house of the Legislature. The Legislature may not in any manner allow the Commonwealth credit to be given or loaned to or in aid of any individual, or of any private association, or of any corporation, which is privately owned or managed.

The Commonwealth has waived its sovereign immunity and consented to be sued on contractual obligations, including bonds and notes issued by it and all claims with respect thereto. However, the property of the Commonwealth is not subject to attachment or levy to pay a judgment, and the satisfaction of any judgment generally requires legislative appropriation. Enforcement of a claim for the payment of principal or interest on bonds and notes of the Commonwealth may also be subject to the provisions of federal or Commonwealth statutes, if any, enacted to extend the time for payment or impose other constraints upon enforcement.

As of June 30, 2004, the Commonwealth had three types of long-term debt outstanding, general obligation bonds, special obligation bonds and federal highway grant anticipation notes. The following is a summary of the Commonwealth's debt outstanding by type of debt (amounts in thousands):

	Amount Outstanding
General Obligation Debt:	
General Obligation Bonds:	
Fixed rate	$ 12,203,178
Variable rate	1,364,480
Auction rate securities	401,500
College opportunity bonds	83,578
County debt assumed	675
Grant anticipation notes (inclusive of cross-over refunding notes)	1,908,015
Subtotal - General Obligation Debt	**15,961,426**
Special Obligation Debt:	
Special Obligation Bonds (inclusive of cross-over refunding bonds):	
Fixed rate	$ 1,335,276
Variable rate	86,590
Subtotal - Special Obligation Debt	**1,421,866**
Discount / (Premium) and issuance cost	(1,120)
Total Outstanding Debt	**$ 17,382,172**

A. *General Obligation Bonds*

General Obligation Bonds are authorized and issued primarily to provide funds for Commonwealth-owned capital projects and Commonwealth supported local government improvements. They are backed by the full faith and credit of the Commonwealth and paid from the Governmental Funds, from which debt service principal and interest payments are appropriated. Massachusetts General Laws provide for the allocation of bond proceeds to these authorizations in arrears, as expenditures are made, unless the proceeds are allocated at the time of issuance. In addition, forms of general obligation bonds are issued for specific programs approved by the Legislature. These are as follows:

i. College Opportunity Bonds

Some Commonwealth general obligation debt is issued in the form of College Opportunity Bonds (COBs) as authorized by the Massachusetts General Laws. These bonds are sold to fund the Commonwealth's "U. Plan" which is part of a college savings program administered by the Massachusetts Educational Financing Authority. These bonds are privately placed and are structured to meet the needs of investors in this plan. Such bonds were initially issued in fiscal year 1996, and have been issued in each subsequent fiscal year, including FY04, during which approximately $10,585,000, (including accretion), of such bonds were issued. Outstanding COBs have maturity dates ranging from 2005 through 2023. COBs have an accreting interest component payable at maturity. The annual accretion rate of each COB's maturity is a variable rate equal to the annual change in the Consumer Price Index (CPI) plus 2.0%. Assuming the CPI averages 3.5% during the life of the outstanding COBs the payments due at maturities of the COBs will total approximately $171,533,000, including accretion. In addition, COBs pay current interest in the amount of 0.5% per year of the initial amount still outstanding. The full faith and credit of the Commonwealth back these bonds.

ii. County Debt Assumed

Chapter 38 of the Acts of 1997 and Chapter 300 of the Acts of 1998 abolished governments of several Massachusetts counties on various effective dates. As part of these provisions, the Commonwealth assumed the outstanding debt of Middlesex County on July 1, 1997, of Hampden and Worcester Counties on July 1, 1998, that of Essex County on July 1, 1999 and that of Berkshire County on July 1, 2000. The county debt assumed has become general obligation debt of the Commonwealth. As of June 30, 2004, $675,000 of these obligations remains outstanding.

iii. Variable Rate Demand Bonds

Included in the long-term debt is $1,451,070,000 of general obligation variable rate demand bonds (VRDBs) maturing from 2008 through 2030 in varying amounts, of which $1,267,025,000 is swapped to fixed rates. The redemption schedule for these bonds is included in the bond redemption schedule contained herein. The interest rate on the VRDBs is determined either weekly or daily based on the activity of the Commonwealth's remarketing agents, and interest is paid monthly. On any reset date, holders of the VRDBs can require the Commonwealth (acting through its remarketing and tender agents) to repurchase the bonds (a "put"). The remarketing agent is authorized to use its best efforts to resell any repurchased bonds by adjusting the interest rates offered. The Commonwealth pays an annual fee to the remarketing agents equal to 0.05% of the outstanding par amount of the bonds.

Under the provisions of stand-by bond-purchase agreements entered into by the Commonwealth with certain commercial banks, the remarketing and tender agents are entitled to draw amounts sufficient to pay the purchase price of any bonds that cannot be resold. During any such period, the Commonwealth is required to pay the bank(s) at an interest rate based on their respective prime lending rates. If the remarketing agent is unable to resell any put bonds within six months of the put date, the stand-by bond-purchase agreements include provisions to convert any such bonds to installment loans payable over an extended period of time, with interest payable at a rate based on the bank(s) prime lending rate(s). The stand-by bond-purchase agreements expire on various dates between August of 2005 and December 2013. The Commonwealth is required to renew or replace these agreements as long as the VRDBs remain outstanding. The Commonwealth currently pays an annual fee to maintain these agreements, which range from 0.13% to 0.22% of the par amount of the bonds.

iv Other Variable Rate Bonds

As part of its refunding activities during FY03, the Commonwealth issued $97,455,000 of refunding bonds which pay a variable rate interest that depends on changes in the Consumer Price Index (CPI). These bonds, which pay interest every six months, are not subject to periodic remarketing, nor do bondholders have the right to "put" such bonds back to the Commonwealth.

On June 29, 2004 as part of the Commonwealth's issuance of the Convention and Exhibition Center Special Obligation Bonds, $86,590,000 of such bonds were issued paying a variable rate of interest also indexed to changes in the CPI. Similar to the 2003 Bonds, the Convention Center Bonds pay interest semiannually, but mature serially from FY15 to FY18.

As detailed in the variable rate debt schedule, these CPI based bonds all have been swapped to fixed rates ranging from 4.45% to 5.25%.

v Action Rate Securities

Also included in the long-term debt is $401,500,000 of general obligation Auction Rate Securities (ARS) maturing in varying amounts from 2020 through 2030. The interest rate payable on the bonds changes weekly as determined pursuant to specified auction procedures. Interest on the bonds is payable weekly. In the case of a failed auction (i.e., insufficient bids to clear the market) existing buyers may be required to hold their bonds with interest payable at a rate equal to a percentage of an ARS industry index, up to a maximum rate of 12.0%.

B. *Special Obligation Bonds*

The Commonwealth also issues special obligation revenue bonds as authorized by Massachusetts General Laws. Such bonds may be secured by all or a portion of revenues credited to the Highway Fund and are not general obligations of the Commonwealth. At June 30, 2004, the Commonwealth had outstanding $1,405,930,000 of such special obligation bonds, of which $1,331,946,000 is allocated to debt not subject to the Commonwealth's statutory debt limit. These bonds are secured by a pledge of 6.86 cents of the 21 cent motor fuel excise tax imposed on gasoline.

In June of 2002, the Commonwealth sold $319,130,000 of special obligation revenue bonds, Series 2002A. Of this amount, $183,180,000 was issued to refund prior special obligation bonds. The remainder was used to fund capital spending in the Commonwealth. The escrow funded by the refunding bonds and related premium will be used only to secure the principal related to $190,075,000, (as well as exclusive of related call premiums) in previously issued special obligation bonds, some of which matured on June 1, 2004 and others will mature in June 1, 2006 and 2008. The interest related to these maturities is not secured by this escrow. Rather, it will be paid from the existing stream of motor fuel excise taxes. Interest on a portion of the newly issued refunding bonds will be paid from the proceeds of the escrow until the aforementioned prior bonds are called for redemption. This technique, which is generally referred to as a "crossover refunding," results in economic savings to the Commonwealth similar to a normal refunding, but does not meet the accounting definition of defeasance of debt, in which case the defeased debt and the related escrow accounts would have been removed. Until such time as the escrow is used to repay the principal of the refunded bonds, such amounts will be reported in the Highway Capital Projects Fund. As of June 30, 2004, $122,315,000 of these amounts remained outstanding.

On June 29, 2004, the Commonwealth issued $686,715,000 of Special Obligation Bonds to permanently finance the costs of construction or renovation of the Commonwealth's convention and exhibition centers in Boston, Springfield and Worcester. To date, these projects were financed primarily through the issuance of notes. The total proceeds from the sale were approximately $706,729,000. The bonds are secured solely by pledged receipts of tax revenues within special districts surrounding those facilities and certain other moneys or securities established within credit facilities. The bonds mature from FY15 to FY34.

C. *Federal Highway Grant Anticipation Notes*

The Commonwealth also issued Federal Highway GANs to finance current cash flow for the Central Artery/Tunnel Project in anticipation of future federal reimbursements. Section 9 through 10D of Chapter 11 of the Acts of 1997, as amended by Chapter 121 of the Acts of 1998, authorizes the Commonwealth to sell up to $1,500,000,000 in GANs. All Federal Highway Construction reimbursements and reimbursements from the federal highway construction trust funds are pledged to the repayment of the GANs. These notes are secured by the pledge of Federal Highway Construction Reimbursements without a general obligation pledge. Under certain limited circumstances, a portion of the revenue from the Commonwealth's motor fuels excise tax may be used to pay debt service on the GANs.

In July of 2004, the Commonwealth sold $408,015,000 of GANs refunding notes, Series 2003A. These notes are Special Obligations of the Commonwealth. The escrow funded by the notes will be used to secure the principal related to $418,340,000 of GANs, including related call premiums, in previously issued series callable on December 15, 2008 and 2010. The interest related to these maturities is not secured by this escrow. Rather, it will be paid from Commonwealth appropriations or the existing stream of future federal grants. Interest on the newly issued refunding notes will be paid from the proceeds of the escrow until the aforementioned prior notes are called for redemption. For the purposes of the pledge but not for accounting purposes, at the time of call, the refunding notes will become GANs. This results in economic savings to the Commonwealth similar to a normal refunding, but does not meet the accounting definition of defeasance of debt, in which case the defeased debt and the related escrow accounts would have been removed. Until such time as the escrow is issued to repay the principal of the refunded notes, such amounts will be reported in the Grant Anticipation Note Trust Fund. As a result of this transaction, the Commonwealth will reduce its debt service by $23.9 million over the next 12 years, resulting in an economic gain of $15.4 million on a present value basis. Inclusive of the cross-over refunding notes, at June 30, 2004, the Commonwealth has $1,907,340,000 of GANs outstanding, including accreted interest on capital appreciation bonds with maturity dates ranging from 2006 to 2015.

D. *Interest Rate Swap Agreements*

The Commonwealth enters into interest rate swap agreements to modify interest rates on outstanding debt. Other than the net interest expenditures resulting from these agreements, no amounts are recorded in the financial statements.

Objective of the Interest Rate Swap Agreements

In connection with the issuance of variable rate refunding bonds in 1997, 1998, 2001 and 2003, the Commonwealth entered into interest rate swap agreements with certain counterparties. The purpose of these agreements is to effectively fix the interest rate payable on the corresponding variable rate refunding bonds, and to achieve an all-in synthetic interest rate that is lower than the rate that could have been achieved on a natural fixed rate basis at the time the agreements were entered into.

Terms of the Interest Rate Swap Agreements

The bonds and related swap agreements have final maturities ranging from 2013 to 2021. The swaps' total notional value of $1,451,070,000 matches the par amount of the related variable rate refunding bonds. Under the swap agreements, the Commonwealth pays the relevant counterparties' fixed rates ranging from 4.15% to 5.25% and receives variable rate payments equal to the amount of variable rate payments the Commonwealth pays on the related variable rate refunding bonds.

The following chart details the Commonwealth's outstanding swaps and related bond issuances:

Associated Bond Issue	Notional Amounts (thousands)	Effective Date	Fixed Rate Paid (Range)	Variable Rate Received	Fair Market Values (thousands)	Final Termination Date	Counterparty Credit Rating
General Obligation Bonds:							
Series 1997B	$ 162,768	8/12/1997	4.659%	Actual Bond Rate	$ (12,949)	August 1, 2015	AA+/Aaa
Series 1997B	108,512	8/12/1997	4.659%	Actual Bond Rate	(11,005)	August 1, 2015	AAA/Aaa
Series 1998A & B	299,712	9/17/1998	4.174%	Actual Bond Rate	(19,219)	September 1, 2016	AAA/Aaa
Series 1998A & B	199,808	9/17/1998	4.174%	Actual Bond Rate	(8,219)	September 1, 2016	AAA/Aaa
Series 2001B & C	496,225	2/20/2001	4.150%	Actual Bond Rate	(31,836)	January 1, 2021	AAA/Aaa
Series 2003B	87,455	3/12/2003	4.500%	Actual Bond Rate	1,521	March 1, 2014	AA+/Aaa
Series 2003B	10,000	3/12/2003	4.500%	Actual Bond Rate	297	March 1, 2013	A/A2
Subtotal	1,364,480				$ (81,410)		
Special Obligation Dedicated Tax Revenue Bonds (CPI Based Swaps):							
Series 2004	28,863	6/29/2004	4.45% - 5.25%	Actual Bond Rate	(1,301)	January 1, 2018	A/A1
Series 2004	28,863	6/29/2004	4.45% - 5.25%	Actual Bond Rate	(1,303)	January 1, 2018	A+/Aa3
Series 2004	28,863	6/29/2004	4.45% - 5.25%	Actual Bond Rate	(1,078)	January 1, 2018	AA-/Aa2
Subtotal	86,590				$ (3,682)		
Total	$ 1,451,070				$ (85,092)		

Fair Market Value of the Interest Rate Swap Agreements

Swap rates for the types and remaining terms of the Commonwealth's swap agreements are generally lower (as of June 30, 2004) than those that prevailed when the various swap contracts were entered into. This is the result of two factors: (1) lower interest rates in general; and (2) the shortening of the remaining terms of the swap contracts due to the passage of time and an upward sloping yield curve for such instruments. As a result, the Commonwealth's swap agreements have an estimated fair market value of negative $85,092,000 as of June 30, 2004. If all the Commonwealth's swap agreements had been terminated as of the end of fiscal year 2004, the Commonwealth would have been required to make a payment of this magnitude. Although the Commonwealth has the option of terminating its swap agreements at any time (and either make or receive any termination payment due), the Commonwealth's counterparties do not have such an option. Therefore, the Commonwealth would only have to make a payment of the magnitude estimated if certain termination events occurred, as described below.

Credit Risk of the Interest Rate Swap Agreements

The swap contracts require that the Commonwealth's counterparties maintain certain ratings levels. If they fail to maintain such ratings, the Commonwealth could choose to terminate the related swap agreement and receive or pay a termination payment depending on the interest rates at the time. Similarly, the Commonwealth is required to maintain a certain credit rating under the agreements, generally in the "A" category. If the Commonwealth's rating fell below those levels, the Commonwealth's counterparties could choose to make variable rate payments based on a market index (instead of the actual bond rate) which would subject the Commonwealth to basis risk, as noted below.

Basis, Market and Rollover Risk of the Interest Rate Swap Agreements

Because the terms on the interest rate swap agreements require the Commonwealth's counterparties to make variable rate payments equal to those the Commonwealth makes on the related variable rate bonds, the Commonwealth is not generally subject to any basis or market risk as a result of these agreements. Under certain circumstances, such as a downgrade of the credit rating of the bonds or the enactment of tax-related legislation which causes the related bonds to trade differently, the swap agreements provide that the Commonwealth's counterparties, may, at their option, pay a variable rate that is based on one or more market indicies such as LIBOR or the BMA swap index. Under these circumstances, the Commonwealth would be subject to basis risk if these indicies varied significantly from the variable rates that were determined for the Commonwealth's variable rate demand bonds through the associated remarketing process.

The swap contracts have the same maturity dates and amortizations as the related bonds. Therefore, the Commonwealth is not subject to any rollover risk as a result of these agreements.

Termination Risk of the Interest Rate Swap Agreements

The swap contracts use the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. The swap agreements are not otherwise subject to termination except at the Commonwealth's option. If one or more of the swap agreements were terminated, then related variable rate bonds would no longer be hedged and the Commonwealth would no longer be paying a synthetic fixed rate with respect to the bonds. In addition, if at the time of termination, the swap had a negative fair value, the Commonwealth would incur a loss and would be required to settle with the related counterparty or counterparties at the swaps' fair market values.

Interest Rate Swap Agreement Dispute

The Commonwealth is party to an interest rate swap agreement relating to the Commonwealth's General Obligation Refunding Bonds, 2001 Series B and 2001 Series C, pursuant to which the Commonwealth makes payments at a fixed rate of 4.15% per annum and receives payments from its swap counterparty at a floating rate based on the actual rate on its bonds, which are variable rate obligation bonds. The notional amount of the swap currently is $496,225,000 and the scheduled termination date is January 1, 2021. Swap payments are made monthly, with the Commonwealth netting its fixed rate obligation against the floating rate amount due from the swap counterparty. The swap documentation provide that the method for determining the floating rate obligation of the counterparty may change upon an "Event of Taxability" as defined therein. The swap counterparty has asserted that an Event of Taxability has occurred and that, as a result, commencing May 3, 2004, the Commonwealth's monthly net payments to the counterparty must be increased. The Commonwealth disagrees with this assertion and, on April 23, 2004, filed a complaint in Suffolk County Superior Court seeking a declaratory judgment and related preliminary injunction relief. The swap payment made by the Commonwealth on May 3, 2004 and each monthly payment made thereafter have been calculated based on the pre-existing method. Had they been calculated as asserted by the swap counterparty, under market conditions on each such payment date through

October 1, 2004, the payments would have been approximately $1.0 million greater in the aggregate. The termination value of the swap as of June 30, 2004 is believed to have been approximately $31.8 million in favor of the swap counterparty and will vary from time to time. The Commonwealth has continued to make net swap payments based on its actual variable rate bond payments pending legal developments.

Debt service on the variable rate bonds is as follows (assuming a short term rate of 2% and a CPI rate of 3%):

Fiscal Year Ending June 30	Variable-Rate Bonds Principal	Variable-Rate Bonds Interest	Interest Rate Swaps, Net	Total
2005	$ -	$ 32,623,645	$ 31,965,358	$ 64,589,003
2006	-	32,623,645	31,965,358	64,589,003
2007	-	32,623,645	31,965,358	64,589,003
2008	2,340,000	32,588,545	31,927,204	66,855,749
2009	3,870,000	32,518,795	31,851,386	68,240,181
2010-2014	495,555,000	142,580,842	136,844,068	774,979,910
2015-2019	753,465,000	50,875,480	49,818,691	854,159,171
2020-2024	195,840,000	4,214,800	4,530,910	204,585,710
Total	$ 1,451,070,000	$ 360,649,397	$ 350,868,333	$ 2,162,587,730

E. *Outstanding Debt*

For financial reporting purposes, long-term debt is carried at its face value, which includes discount and any issuance costs. The outstanding amount represents the total principal to be repaid. For capital appreciation bonds, the outstanding amount represents total principal and accreted interest to be repaid. When short-term debt has been refinanced on a long-term basis, it is reported as outstanding at its face amount.

The amount of long-term debt authorized but unissued is measured in accordance with the statutory basis of accounting. Only the net proceeds (exclusive of discount and costs of issuance) are deducted from the total authorized by the Legislature.

Long-term debt outstanding (including discount and issuance cost) and debt authorized and unissued at June 30, 2004 is as follows (amounts in thousands):

Purpose	Bonds Outstanding	Fiscal Year Maturities	Authorized and Unissued
GANs.........................	$ 1,907,340	2006-2015	$ -
Capital Projects:			
General....................	5,496,512	2005-2031	3,958,557
Highway..................	8,774,386	2005-2034	2,666,991
Local Aid.................	1,142,134	2005-2031	99,146
Other.......................	61,800	2005-2029	103,299
	15,474,832		6,827,993
Total...........................	$ 17,382,172		$ 6,827,993

Interest rates on the Commonwealth's debt outstanding at the end of FY04 ranged from 0.0% to 8.0%.

Changes in long-term debt outstanding (including discount and issuance cost) and bonds authorized - unissued for the year ended June 30, 2004 are as follows (amounts in thousands):

	Bonds Outstanding	Authorized and Unissued
Balance July 1, 2003	$ 15,962,506	$ 8,721,581
General and special obligation bonds:		
Principal, less discount and issuance costs	1,993,086	(1,993,086)
Net premium and issuance costs	(67,096)	-
General obligation refunding bonds:		
Principal on Refunding Bonds	2,936,710	-
Principal on Refunded Bonds	(2,750,667)	-
Retired discount on Refunded Bonds	66,077	-
Increase in bonds authorized	-	310,461
Decrease in bonds authorized		(210,963)
Bonds retired	(758,444)	-
Balance June 30, 2004	$ 17,382,172	$ 6,827,993

At June 30, 2004, debt service requirements to maturity for principal (including discount, capital appreciation and issuance costs) and interest including all variable rate interest not hedged by swap agreements (assumed interest rate is 5%) are as follows (amounts in thousands):

Fiscal Year Ended June 30,	Principal	Interest	Total
2005	$ 880,272	$ 843,653	$ 1,723,925
2006	998,102	829,576	1,827,678
2007	1,038,302	779,519	1,817,821
2008	1,069,225	725,953	1,795,178
2009	1,076,809	671,376	1,748,185
2010-2014	5,116,215	2,519,304	7,635,519
2015-2019	3,455,335	1,360,286	4,815,621
2020-2024	2,252,708	634,770	2,887,478
2025-2029	872,914	292,264	1,165,178
2030-2032	622,290	59,900	682,190
Total	$ 17,382,171	$ 8,716,601	$ 26,098,773

The Commonwealth issued bonds and notes through both competitive and negotiated sales during FY04. The costs for legal counsel and underwriting fees for bond sales were $879,000 and $23,884,000 respectively. In addition, the Commonwealth paid $156,000 for disclosure counsel services.

F. *Bonds Defeased Through Refunding during FY04*

As authorized by the Massachusetts General Laws, the Commonwealth advance refunded certain general obligation bonds through the issuance of $2,528,695,000 of general obligation refunding bonds (exclusive of the aforementioned special obligation refunding bonds) during FY04. Net proceeds totaling approximately $2,829,668,000 were used to purchase U.S. Government and U.S. Government Agency securities which were deposited in irrevocable trusts with an escrow agent to provide for all future debt service payments of the refunded bonds. As a result, the refunded bonds are considered to be defeased, and the liabilities therefore have been removed from the General Long-term Obligations Account Group. As a result of these refundings, the Commonwealth decreased current year debt service payments and has taken advantage of lower interest rates, and it has decreased its aggregate debt service payments by approximately $203,600,000 over the next 20 years and will experience an economic gain (the difference between the present values of the debt service payments of the refunded and refunding bonds) of approximately $107,200,000. At June 30, 2004, approximately $1,940,005,000 of the bonds refunded remain outstanding and are defeased.

G. *Prior Defeasance*

In prior years, the Commonwealth defeased certain general and special obligation bonds by purchasing securities (from the proceeds of refunding bonds or from surplus operating funds) and placing them in irrevocable trusts to provide for all future debt service payments on the defeased bonds. Accordingly, the trust account assets and the liabilities for the defeased bonds are not included in the financial statements. At June 30, 2004, approximately $4,327,954,000 of bonds outstanding from activities in prior fiscal years are considered defeased.

H. *Statutory Debt Limit*

The Massachusetts General Laws establish limits on the amount of direct debt outstanding. By statutorily limiting the Commonwealth's ability to issue direct debt, this limit provides a control on annual capital spending. The direct debt limit for FY04 was approximately $12,822,414,000. Outstanding debt subject to the limit at June 30, 2004 was approximately $12,459,055,000. The limit increases 5% per year.

For purposes of determining compliance with the limit, outstanding direct debt is defined to include general obligation bonds and minibonds at the amount of their original net proceeds. It excludes BANs and discount and issuance costs, if any, financed by these bonds. It also excludes special obligation bonds, GANs, refunded bonds, certain refunding bonds, debt issued by counties, and debt issued in conjunction with the MBTA forward funding.

The amounts excluded from the debt limit are as follows (amounts in thousands):

	Debt Outstanding
Balance June 30, 2004	$ 17,382,172
Less amounts excluded:	
Discount and issuance cost	1,120
Special Obligation Principal	(1,347,882)
GANs Principal	(1,908,015)
County Debt Assumed	(675)
MBTA Forward Funding	(601,027)
Central Artery Tunnel	(1,066,638)
Outstanding Direct Debt	$ 12,459,055

I. ***Subsequent Bond Issuances***

In August of 2004, the Commonwealth sold $300,000,000 of General Obligation Bonds, 2004 Series C. The proceeds were used to fund capital spending.

In August of 2004, the Commonwealth issued an additional series of College Opportunity Bonds totaling $12,682,000. This includes an initial amount of $7,118,000 plus an expected $5,564,000 in interest to be accreted through maturity.

7. LEASES

In order to finance the acquisition of equipment, the Commonwealth has entered into various lease / purchase agreements, including tax-exempt lease purchase (TELP) agreements, which are accounted for as capital leases. Lease agreements are for various terms and contain clauses indicating that their continuation is subject to appropriation by the Legislature. For the fiscal year ended June 30, 2004, capital lease / purchase expenditures totaled approximately $34,790,000.

At June 30, 2004, the Commonwealth's aggregate outstanding liability under capital leases, based on the present value of the net minimum lease payments, totaled approximately $131,843,000. This liability is reported in the General Long-Term Obligations Account Group. Equipment acquired under capital leases and included in the General Fixed Assets Account Group totaled approximately $160,440,000.

The Commonwealth has numerous operating lease agreements for real property and equipment with varying terms. These agreements contain provisions indicating that continuation is subject to appropriation by the Legislature.

Certain colleges have capital leases for energy projects with guaranteed energy savings. The result of these savings yields zero interest due from 2014 – 2022 on these leases.

Operating lease expenditures for the fiscal year ended June 30, 2004 were approximately $192,268,000.

The following is a schedule of future minimum payments under non-cancelable leases as of June 30, 2004 (amounts in thousands):

	Capital Leases		Operating	
	Principal	Interest	Leases	Total
2005…………	$ 34,897	$ 6,157	$ 167,626	$ 208,680
2006…………	29,015	4,746	110,075	143,836
2007…………	22,840	3,395	82,822	109,057
2008…………	21,032	2,816	53,254	77,102
2009…………	7,292	888	36,947	45,127
2010-2014…..	16,767	1,278	115,002	133,047
2015-2019…..	-	9	45,982	45,991
2020-2023…..	-	-	45,982	45,982
2024-2028…..	-	-	45,982	45,982
2029-2033…..	-	-	36,789	36,789
Total…………	$ 131,843	$ 19,289	$ 740,461	$ 891,593

8. INDIVIDUAL FUND DEFICITS

In order to resolve the deficits in the budgeted funds, the Comptroller has recommended authorization of transfers from other budgeted funds with surplus balances or a plan of fund consolidation. For the Non-Budgeted Special Revenue Funds, the Comptroller has recommended similar budgeted transfers to subsidize and resolve the deficits or consolidation of such funds into budgeted funds. In both cases, such steps require legislative action.

The Capital Projects Fund deficit reported in the following table reflects the time lag between capital expenditures and the sale of related bonds. To arrive at the combined capital projects fund balance, this individual fund deficit is offset by capital funds earmarked in the Central Artery Statewide Road and Bridge Infrastructure Fund of $732,581,000, $134,182,000 held in escrow for the Series 2002A Special Obligation Bonds and $82,160,000 in reserve for the other Capital Projects Funds.

The following Budgeted, Non-Budgeted Special Revenue and Capital Projects Funds are included in the combined totals and have individual fund deficits at June 30, 2004, as follows (amounts in thousands):

Budgeted Funds:	
Highway Fund	$ 716,533
Children's and Seniors' Health Care Assistance Fund	161,665
Total Budgeted Funds	878,198
Non-Budgeted Special Revenue:	
Other:	
Government Land Bank Fund	35,097
Mosquito and Greenhead Fly Control Fund	81
Motor Vehicle Safety Inspection Trust Fund	25,655
Total Non - Budgeted Funds	60,833
Capital Projects:	
General Capital Projects Fund	282,206
Capital Investment Trust Fund	755
Capital Improvements and Investment Trust Fund	7,224
Capital Expenditure Reserve Fund	98,829
Highway Capital Projects Fund	176,565
Government Land Bank Capital Project Fund	5,000
Local Capital Projects Fund	13,495
Total Capital Projects Funds	584,074
Total	$ 1,523,105

9. MEDICAID COSTS

The Commonwealth provides medical care for low-income, elderly and other residents who qualify for such assistance under the federally-sponsored Medical Assistance Program (Medicaid). The Commonwealth pays the full cost of care and is reimbursed by the federal government for 50% of that cost. For the fiscal year ended June 30, 2004, the General Fund, and Children's and Seniors' Health Fund include $5,742,398,000 in expenditures for Medicaid claims processed for payment.

The combined financial statements – statutory basis include Medicaid claims processed but unpaid at June 30, 2004 of approximately $177,038,000 as accounts payable. The Commonwealth estimates its total liability, as determined in accordance with GAAP, at $736,100,000 including the amounts reported as accounts payable at June 30, 2004. This amount includes estimates of both the cost of care provided as of June 30, 2004, for which claims have not been processed and other costs. Of this amount, $387,381,000 is expected to be reimbursed by the federal government and third party recoveries.

10. RETIREMENT SYSTEMS

A. *Primary Government*

The Commonwealth is statutorily responsible for the pension benefits for Commonwealth employees (members of the State Employees' Retirement System) and for teachers of the cities, towns, regional school districts throughout the Commonwealth and Quincy College (members of the Teachers' Retirement System, except for teachers in the Boston public schools, who are members of the State-Boston Retirement System but whose pensions are also the responsibility of the Commonwealth). The members of the retirement systems do not participate in the Social Security System.

The Commonwealth has assumed responsibility for payment of cost-of-living adjustments (COLA) for the separate (non-teacher) retirement systems of its cities, towns and counties, granted in fiscal year 1981 to 1996. The Commonwealth is statutorily required to have an actuarial valuation once every three years and every two years to confirm to the requirements of GAAP.

B. *Plan Descriptions*

The *State Employees' Retirement System* (SERS) is a single employer defined benefit public employee retirement system (PERS), covering substantially all employees of the Commonwealth and certain employees of the independent authorities and agencies, including the state police officers at the Massachusetts Port Authority and the Massachusetts Turnpike Authority. The SERS is administered by the Commonwealth and is part of the reporting entity and does not issue a stand alone financial report.

The *Teachers' Retirement System* (TRS) is an agent multiple employer defined benefit PERS. The Commonwealth is a non-employer contributor and is responsible for all contributions and future benefit requirements of the TRS. The TRS covers certified teachers in cities (except the City of Boston), towns, regional school districts and Quincy College. The TRS is administered by the Commonwealth and is part of the reporting entity and does not issue a stand-alone financial report.

The *State – Boston Retirement System* (SBRS) is a hybrid multiple employer defined benefit PERS. SBRS provides pension benefits to all full-time employees upon commencement of employment with any of the various government agencies covered by SBRS. The Commonwealth is a non-employer contributor and is only responsible for the actual cost of pension benefits for SBRS participants who serve in the City of Boston's School Department in a teaching capacity (BTRS). The cost of pension benefits of the other participants is the responsibility of the City of Boston. SBRS is not administered by the Commonwealth and is not part of the reporting entity and a stand-alone financial report is not available

Certain Commonwealth employees and current retirees employed prior to the establishment of the State Employees' Retirement System are covered on a "pay-as-you-go" basis. During the year ended June 30, 2004, the Commonwealth's pension expenditure included payments totaling $14,567,000 to current retirees employed prior to the establishment of the current plans and the non-contributory plans.

The policy for post-retirement benefit increases for all retirees of the SERS, TRS, BTRS and COLA of local governments is subject to legislative approval.

Membership – Membership in SERS, TRS and BTRS as of January 1, 2004, the date of the most recent valuation, is as follows:

	SERS	TRS	BTRS
Retirees and beneficiaries currently receiving benefits................	51,418	39,341	2,992
Terminated employees entitled to benefits but not yet receiving them....	2,966	N/A	169
Subtotal..	54,384	39,341	3,161
Current employees:			
Vested*..	41,229	43,978	3,432
Non-vested*...	38,893	43,956	2,523
Subtotal..	80,122	87,934	5,955
Total...	134,506	127,275	9,116

* Estimated

C. ***Benefit Provisions***

Massachusetts General Laws establish uniform benefit and contribution requirements for all contributory PERS. These requirements provide for retirement allowance benefits up to a maximum of 80% of a member's highest three-year average annual rate of regular compensation. Benefit payments are based upon a member's age, length of creditable service, and group creditable service, and group classification. The authority for amending these provisions is with the Legislature.

Members become vested after ten years of creditable service. A superannuation retirement allowance may be received upon the completion of twenty years of service or upon reaching the age of 55 with ten years of service. Normal retirement for most employees occurs at age 65; for certain hazardous duty and public safety positions, normal retirement is at age 55.

D. ***Funding Progress***

During FY01, the Legislature passed Chapter 114 of the Acts of 2000, which modified Chapter 32 of the General Laws. This modification became effective on July 1, 2001. In Chapter 114, teachers who are members of the State Teachers Retirement System, or teachers who are members of the State – Boston Retirement System before 1975, who resigned or took an unpaid leave of absence because of maternity leave will be allowed to "buy back" into the fund up to a maximum of four years. The member must pay the amount determined by the Retirement Board by December 31, 2001 to qualify, as long as the member has worked longer than ten years. If the member completes ten years of service after December 31, 2001, payment can be made within 18 months of completion of ten years of service. In addition, the law creates a superannuation retirement benefit program for all teachers hired on or after July 1, 2001. This program has a contribution rate of 11 percent of regular compensation. To be eligible for the alternative benefit at retirement, the teacher must have completed thirty years of eligible service. All previous members may elect to participate in the program, as long as they participate with the equivalent of a minimum of five years of employee contributions at the new rate. If the member retires before five years, the teacher must pay into the system, the amount that would have been paid in one lump sum, or in installments as the Board may prescribe. The alternative benefit is calculated as the percentage of average compensation determined under the current formula increased by 2% of the average annual compensation for each full year of service in excess of 24 years. The election to participate is irrevocable.

The following table presents the schedule of funding progress as presented in the most recent actuarial valuations at the dates indicated (amounts in thousands):

Actuarial Valuation as of January 1	Actuarial Value of Plan Assets	Actuarial Accrued Liability	Unfunded Actuarial Liability (UAL)	Funded Ratio %	Annual Covered Payroll *	UAL as a % of Covered Payroll
State Employees' Retirement System						
2004	$ 15,931,000	$ 18,966,000	$ 3,065,000	84.0 %	$ 3,842,000	79.8 %
2003	13,947,000	17,551,000	3,604,000	79.5	3,779,000	95.4
2002	15,002,000	15,961,000	959,000	94.0	4,034,000	23.8
2001	13,922,000	15,170,000	1,248,000	91.8	3,700,000	33.7
2000	13,364,000	14,138,000	773,000	94.5	3,472,000	22.3
1998	9,914,000	11,361,000	1,447,000	87.3	3,111,000	46.5
1996	7,366,000	9,441,000	2,075,000	78.0	2,989,000	69.4
1995	5,879,000	8,602,000	2,723,000	68.3	2,992,000	91.0
1993	5,071,000	8,738,000	3,667,000	58.0	2,919,000	125.6
Teachers' Retirement System						
2004	17,075,000	24,519,000	7,444,000	69.6	4,556,000	163.4
2003	14,762,000	22,892,000	8,129,000	64.5	4,406,000	184.5
2002	15,712,000	20,620,000	4,908,000	76.2	4,264,000	115.1
2001	14,390,000	18,170,000	3,779,000	79.2	4,072,000	92.8
2000	13,681,000	16,420,000	2,739,000	83.3	3,704,000	73.9
1998	10,170,000	13,095,000	2,925,000	77.7	3,175,000	92.1
1996	7,553,000	10,252,000	2,699,000	73.7	2,810,000	96.0
1995	6,014,000	9,712,000	3,698,000	61.9	2,667,000	138.7
1993	5,142,000	8,921,000	3,779,000	57.6	2,428,000	155.6
State - Boston Retirement System (Boston Teachers)						
2004	1,040,000	2,022,000	982,000	51.4	368,000	266.8
2003	919,000	1,918,000	998,000	47.9	387,000	257.9
2002	984,000	1,756,000	772,000	56.0	370,000	208.6
2001	918,000	1,502,000	583,000	61.1	304,000	191.8
2000	860,000	1,381,000	521,000	62.3	285,000	182.8
1998	699,000	1,219,000	520,000	57.3	285,000	182.5
1996	549,000	1,025,000	476,000	53.6	274,000	173.7
1995	438,000	833,000	395,000	52.6	232,000	170.3
1993	370,000	743,000	373,000	49.8	206,000	181.1

* - The covered payroll amounts approximate the employer payroll.

E. ***Pension Actuarial Valuation***

The Commonwealth's pension actuarial valuation was performed as of January 1, 2004 pursuant to Chapter 32 of the General Laws of the Commonwealth of Massachusetts and based on the plan provisions at that time. The following are the most significant assumptions used in preparing the 2004 actuarial valuation:

Investment return……………………………	8.25% per year
Interest rate credited to annuity savings……	3.5% per year
Cost of living increases……………………	3% per year
Mortality……………………………………	RP-2000 Health Annuitant table projected with scale AA (gender distinct). This is applicable to both pre-retirement and post-retirement benefits. Adjustments made for disabled members and certain other groups.
Salary Increases……………………………	Based on analysis of past experience - ranges from 4.75% to 8.5% for groups 1 and 2, 5.5% to 9.5% for group 3, 5.5% to 12% for group 4 and 4.75% to 9.5% for teachers.

F. *Contributions Required and Contributions Made*

The total contributions required for SERS, TRS and SBRS are based on the entry age normal cost method using the same actuarial assumptions used to compute the net pension obligation.

The Commonwealth was financially responsible for the COLA granted to participants in the 104 retirement systems of cities, towns and counties in fiscal year 1981 to 1996. Chapter 17 of the Acts of 1997 effective for fiscal year 1998 transferred the responsibility for funding COLAs for separate (non-teacher) retirement systems of cities and towns to the respective system. Any future COLA granted by the Legislature to employees of these plans will be the responsibility of the individual system. The individual employer governments are also responsible for the basic pension benefits. The retirement systems are not administered by the Commonwealth and are not part of the reporting entity. The actuarial accrued liability for COLA as of January 1, 2004 was $522,000,000.

The retirement systems' funding policies have been established by Chapter 32 of the Massachusetts General Laws. The Legislature has the authority to amend these policies. The annuity portion of the SERS, TRS and BTRS retirement allowance is funded by employees, who contribute a percentage of their regular compensation. Costs of administering the plan are funded out of plan assets.

Member contributions vary depending on the most recent date of membership:

Hire Date	% of Compensation
Prior to 1975…………………………………	5% of regular compensation
1975 - 1983…………………………………	7% of regular compensation
1984 to 6/30/1996……………………..….	8% of regular compensation
7/1/1996 to present…………………………	9% of regular compensation except for State Police which is 12% of regular compensation
7/1/2001 to present…………………………	11% of regular compensation (for teachers hired after 7/1/01 and those accepting provisions of Chapter 114 of the Acts of 2000)
1979 to present……………………………	An additional 2% of regular compensation in excess of $30,000

The Commonwealth's contribution for the pension benefit portion of the retirement allowance of SERS and TRS and required payments to cover BTRS and COLA contributions were originally established on a "pay-as-you-go" basis. As a result, amounts were appropriated each year to pay current benefits, without a systematic provision to fully fund future liabilities already incurred. Beginning in fiscal year 1988, the Commonwealth enacted the Pension Reform Act of 1987 and addressed the unfunded liability of SERS, TRS and its participation in SBRS and its COLA obligation.

This legislation also directed the Secretary of Administration and Finance to prepare a funding schedule to meet these requirements, and to update his funding schedule every three years on the basis of new actuarial valuation reports prepared under the Secretary's direction. Any such schedule is subject to legislative approval. If a schedule is not so approved, payments are to be made in accordance with the most recently approved schedule. Under the current schedule adopted in 2004, the amortization payments are designed to eliminate the unfunded liability by fiscal year 2023 on a 4.50% increasing basis. Contributions by the Commonwealth of $687,335,000 were made during the fiscal year ended June 30, 2004. Of this amount $71,198,000 represents payments for COLA granted to participants in retirement systems of cities, towns and counties. The Commonwealth schedule encompasses SERS, TRS and Boston Teachers.

GAAP requires that pension expenditures (costs) be based on an acceptable actuarial cost method and that they be not less than:

- Normal cost plus amortization of net pension obligation cost
- Interest and amortization on any unfunded prior service costs

The funding schedule discussed above follows an acceptable actuarial funding methodology to compute normal cost and the unfunded accrued actuarial liability.

The following table presents the schedule of employer contributions (amounts in thousands):

Actuarial Valuation as of January 1	Annual Required Contribution (ARC)	Interest on NPO	Amortization of NPO	Pension Cost	Actual Contribution Made	Net Pension (Obligation) Asset (NPO)	% of ARC Contributed	% of Pension Cost Contributed
State Employees' Retirement System								
2004	$ 349,557	$ (109,346)	$ (90,749)	$ 330,960	$ 246,754	$ 1,241,195	71 %	75 %
2003	397,698	(117,299)	(96,940)	377,338	280,929	1,325,401	71	74
2002	215,795	(111,506)	(92,152)	196,441	266,660	1,421,811	124	136
2001	275,204	(109,731)	(133,387)	298,861	320,381	1,351,592	116	107
2000	352,084	(108,400)	107,190	350,873	367,000	1,330,071	104	105
1999	319,454	(103,188)	98,556	314,822	378,000	1,313,944	118	120
1998	261,255	(83,446)	77,180	254,989	494,289	1,250,766	189	194
1997	246,037	(65,478)	41,889	222,448	463,590	1,011,466	188	208
1996	232,158	(46,918)	29,523	214,763	433,114	770,324	187	202
1995	249,640	(31,639)	19,614	237,615	417,361	551,973	167	176
Teachers' Retirement System								
2004	610,841	(65,373)	(54,255)	599,722	359,476	552,153	59	60
2003	651,021	(83,468)	(68,980)	636,534	417,204	792,400	64	66
2002	411,225	(82,377)	(68,079)	396,927	410,143	1,011,729	100	103
2001	475,053	(78,498)	(95,421)	491,976	539,000	998,513	113	110
2000	480,873	(79,487)	78,599	479,985	468,000	951,489	97	98
1999	373,777	(70,312)	67,155	370,620	481,826	963,474	129	130
1998	315,474	(59,126)	54,686	311,034	446,619	852,267	142	144
1997	245,426	(44,832)	28,681	229,275	418,519	716,682	171	183
1996	232,403	(30,311)	19,073	221,165	392,003	527,439	169	177
1995	277,343	(24,002)	14,880	268,221	342,441	356,601	123	128
Boston Teachers Retirement System								
2004	74,787	5,374	4,460	75,701	45,364	(95,480)	61	60
2003	76,151	3,411	2,819	76,743	52,944	(65,142)	70	69
2002	940,003	(67)	(56)	93,992	51,833	41,343	6	55
2001	66,820	1,542	1,875	66,488	86,000	815	129	129
2000	58,266	448	(443)	58,271	45,000	18,697	77	77
1999	53,453	(989)	944	53,409	36,000	5,426	67	67
1998	48,795	(2,114)	1,995	48,636	35,000	11,983	72	72
1997	34,621	(2,082)	1,332	33,871	35,000	25,619	101	103
1996	32,908	(1,860)	1,171	32,219	34,822	24,490	106	108
1995	28,168	(1,816)	1,126	27,478	28,000	21,887	99	102

G. ***Change in Budgetary Funding for Pensions and Transfer of Assets***

In the FY04 GAA, the Legislature changed the funding mechanism for the Commonwealth's pension obligations, moving the funding "off – budget." The original pension funding schedule called for an $832.3 million appropriation. However, the FY04 GAA amended the General Laws to allow annual pension appropriations to be paid at an amount equal to the scheduled amount less the value of any capital assets transferred to the pension liability fund. The FY04 GAA funded the $832.3 million pension obligation using $687.3 million in cash from the General Fund and the transfer to the pension liability fund of the Commonwealth from the Massachusetts Convention Center Authority the Hynes Convention Center and the Boston Common Garage, valued at $145 million. However, the Treasurer and Receiver – General, acting on behalf of the Pension Reserves Investment Management Board, which manages the assets of the pension liability fund, found the valuation on the assets to be transferred from the Massachusetts Convention Center Authority unacceptable. To compensate, the Legislature set the transfers for pensions at $1.2 billion for FY05.

In addition, the FY05 GAA also added certain other pension payments to be funded "off-budget." These payments to veterans and other groups paid pursuant to various acts passed in the 1980's totaled approximately $14.6 million in FY04 and are expected to total a similar amount in FY05.

H. ***Post-retirement Health Care and Life Insurance Benefits***

In addition to providing pension benefits, under Chapter 32A of the Massachusetts General Laws, the Commonwealth is required to provide certain health care and life insurance benefits for retired employees of the Commonwealth, housing authorities, redevelopment authorities, and certain other governmental agencies. Substantially all of the Commonwealth's employees may become eligible for these benefits if they reach retirement age while working for the Commonwealth. Eligible retirees are required to contribute a specified percentage of the health care benefit costs which is comparable to contributions required from employees. The Commonwealth is reimbursed for the cost of benefits to retirees of the eligible authorities and non-state agencies. The Commonwealth recognizes its share of the costs of providing these benefits when paid. These payments totaled approximately $273,828,000 for the fiscal year ended June 30, 2004. There are approximately 53,847 participants eligible to receive benefits at June 30, 2004.

The Commonwealth has not performed an actuarial valuation of its post-retirement health care and life insurance benefit liability. Private industry typically sees an actuarial accrued liability of 10 to 20 times the current annual payments. For the Commonwealth, this would extrapolate to an actuarial accrued liability of $2.5 billion to $5 billion.

The FY04 General Appropriation Act changed the employee contribution rates for group health insurance, with the exception of current employees earning less than $35,000 and retires. Current employees as of July 1, 2003 will contribute 20% to their health insurance costs if they earn over $35,000. New employees will contribute 25%. In fiscal 2006, the contribution rates will return to 15% for all employees.

11. COMMITMENTS

A. ***Regional Transit Authorities***

Under Chapter 161B of the General Laws, the Commonwealth is obligated to provide annual subsidies to certain regional transit authorities for contract assistance, debt service assistance and their net cost of service deficiencies. The FY04 General Appropriation Act amended Chapter 161B. After July 1, 2003, bonds and notes issued by the various authorities are no longer guaranteed by the Commonwealth and are not general obligations of the Commonwealth.

B. ***MBTA and Other Authorities***

The Commonwealth continues to guarantee certain Massachusetts Bay Transportation Authority (MBTA) debt outstanding at June 30, 2004, totaling $2,278,390,000.

The MBTA's forward funding legislation of 1999 provides for the MBTA to issue general obligation, revenue or other debt secured by a pledge or conveyance of all or a portion of revenues, receipts or other assets or funds of the MBTA. This new debt is not backed by the full faith and credit of the Commonwealth.

In addition to the residual obligations of the MBTA, the Commonwealth guarantees debt of a number of Public Authorities. At June 30, 2004, the aggregate outstanding debt for which the Commonwealth is obligated to provide contract assistance support totaled approximately $1,597,957,000 long-term, of which $693,885,000 is for the Route 3 North Transportation Improvements Association and $655,890,000 is for the University of Massachusetts Building Authority. No short-term regional transit authority debt is guaranteed.

In addition, the Commonwealth guarantees the debt of certain local governments and public higher education building authorities but does not provide contract assistance. The majority of these guarantees are for bonds outstanding for certain series' of the University of Massachusetts Building Authority. The Commonwealth guarantees these series of bonds to a maximum of $200 million.

C. ***Saltonstall Building***

The Massachusetts Development Finance Agency (MDFA) was authorized in legislation to undertake redevelopment of the Saltonstall State Office Building and its surrounding area. Under the provisions of MDFA's bond authorization, the building is to be leased by the MDFA for a lease term of up to 50 years with extension terms permitted for an aggregate 30 more years. The MDFA renovated the building and will lease half of it back to the Commonwealth for office space and related parking for a comparable lease term. The remainder of the building and surrounding area has been redeveloped as private office space, housing and retail establishments. Upon completion, the Commonwealth will be obligated for future lease payments for space it rents. However, this obligation is not a general obligation or a pledge of credit of the Commonwealth. Though MDFA's bonds are revenue obligations, with pledges of the public and private lease payments, the Commonwealth's lease payments are due upon occupancy and are subject to annual appropriation. The Commonwealth has commenced occupancy of the building.

D. *Central Artery / Tunnel Project*

The Central Artery / Tunnel Project is the largest single component of the Commonwealth's capital program according to the finance plan filed as of October 1, 2004. The current cost estimate is $14.625 billion. The plan includes a maximum obligation of $8.549 billion from the federal government. The finance plan is currently under review.

At June 30, 2004, the Commonwealth had commitments of approximately $862,829,000 related to ongoing construction projects. The majority relate to construction funding for the Central Artery/Tunnel Project. The Central Artery/Tunnel Project continues to anticipate federal participation and payments from the Massachusetts Turnpike Authority (MTA) and the Massachusetts Port Authority (MassPort).

12. CONTINGENCIES

A number of lawsuits are pending or threatened against the Commonwealth, which arise from the ordinary course of operations. These include claims for property damage and personal injury, breaches of contract, condemnation proceedings and other alleged violations of law. For those cases in which it is probable that a loss will be incurred and the amount of the potential judgment can be reasonably estimated or a settlement or judgment has been reached but not paid, the Attorney General estimates the liability to be approximately $6,650,000 to be paid during FY05. No accrual has been made for this amount in the combined financial statements – statutory basis.

Under the statutory basis of accounting, workers' compensation costs are recognized when claims are presented and paid. The Commonwealth's outstanding liability for such claims at June 30, 2004 is estimated to be $313,800,000, of which approximately $37,660,000 is expected to be paid during FY05. No accrual has been made for these amounts in the combined financial statements – statutory basis.

The Commonwealth receives significant financial assistance from the federal government. Entitlement to these resources is generally contingent upon compliance with terms and conditions of the grant or reimbursement agreements and with applicable federal regulations, including the expenditure of the resources for eligible purposes. Substantially all federal financial assistance is subject to financial and compliance audits. Any disallowances become liabilities of the fund, which received the assistance. At June 30, 2004, the Commonwealth estimated that liabilities, if any, which may result from such audits are not material.

Chapter 200A of the Massachusetts General Laws, the Commonwealth's Abandoned Property Law, requires deposit of certain unclaimed assets into a managed Fiduciary Fund. These unclaimed assets are to be remitted to the General Fund each June 30, where it is included as miscellaneous revenue. Amounts remitted during FY04 totaled approximately $159,864,000. Since inception, approximately $1,320,031,000 has been remitted. A portion of this amount represents a contingency, because claims for refunds can be made by the owners of the property.

A. *Tobacco Settlement*

A Master Settlement Agreement (MSA) was executed in November of 1998 between five tobacco companies and 46 states, including the Commonwealth. The MSA called for, among other things, annual payments to the states in perpetuity. These payments have been estimated to total more than $200 billion over the first 25 years, subject to various offsets, reductions, and adjustments.

In FY04, the Commonwealth received approximately $253,621,000 or 90% of the estimated amounts shown in the MSA. All received amounts were transferred to the General Fund.

On December 19, 2003, a Suffolk Superior Court jury rejected the claims of the Commonwealth’s private tobacco attorneys that they should be paid a fee amounting to 25% of the Commonwealth’s tobacco settlement money. The jury awarded the plaintiffs 10.5% of the amount the Commonwealth receives under the Master Settlement Agreement through 2025. To date, however, the attorneys have received more than 10.5% of what the Commonwealth has received under the MSA. The Commonwealth at present owes nothing under the jury award. Whether the Commonwealth will in the future be required to pay any sum on private counsel’s claim will depend on the actual payments received by the Commonwealth under the MSA through 2025, as well as on the amounts the attorneys receive through the arbitration payments. No appeal was filed within the applicable time period.

B. *Unemployment Compensation Fund*

During FY04, the Commonwealth received interest free loans from the federal government to fund the unemployment compensation operating deficit, the fund balance declined by $368.2 million. All of these borrowings were paid back in May 2004. No additional revenues were needed to be collected from employers in order to pay accrued interest as the loans were interest free. The fund balance in the Unemployment Compensation Fund stands at approximately $122.5 million as of June 30, 2004. On October 13, 2004, the Commissioner of the Division of Unemployment Assistance announced that further loans will be needed in FY05 to pay unemployment benefits.

C. *UMass Dartmouth Lease Revenue Bonds*

In September 2000, the Massachusetts Development Finance Agency issued Lease Revenue bonds (University of Massachusetts at Dartmouth, College of Visual and Performing Arts Project), 2000 Issue (the "UMass Dartmouth Lease Revenue Bonds") in the principal amount of $21,500,000 to finance the acquisition and rehabilitation of a facility to house the College of Visual and Performing Arts for the University of Massachusetts at Dartmouth ("UMass Dartmouth"). The facility was leased by a private limited partnership to the Commonwealth on behalf of UMass Dartmouth. The obligations of the Commonwealth under the lease, which were subject to annual appropriation, were pledged to secure the Lease Revenue Bonds. During the initial months of FY04, monthly lease payments were not paid. Interest and scheduled principal in respect of the UMass Dartmouth Lease Revenue Bonds payable on August 1, 2003 were paid in full from previously available funds. The Governor's FY05 budget recommended a separate appropriation to meet this obligation.

On September 26, 2003 Moody's Investors Service placed the Lease Revenue Bonds on "Watchlist for possible downgrade" citing its belief that the Commonwealth had failed to appropriate lease payments for the facility financed by the UMass Dartmouth Lease Revenue Bonds. At the same time, Moody's also placed on "Watchlist for possible downgrade" the $416.3 million outstanding principal amount of lease revenue bonds of the Route 3 North Transportation Improvements Association. The latter are also secured by a lease, subject to annual appropriation, of the Commonwealth. While the FY04 GAA did contain an express appropriation for the Route 3 North lease, and all amounts due and payable thereunder have been paid by the Commonwealth, Moody's justified the Watchlist classification of the Route 3 North lease revenue bonds by "the exposed weakness in the budget process" of the Commonwealth arising from the supposed failure to appropriate for the lease of the UMass Dartmouth facility.

The Executive Office for Administration and Finance and the Office of the State Treasurer have concluded that the FY04 GAA authorized payment of the UMass Dartmouth lease and that, while the Legislature did not provide a specific line item appropriation for the lease payments, it did so only because it intended that the lease payments be made from a general appropriation of approximately $327.8 million for the University of Massachusetts.

The monthly lease payments were brought current on October 28, 2003 and remain current. On November 24, 2003 Moody's downgraded the Leave Revenue Bonds from "A1" to "A2". At the same time, Moody's confirmed the "Aa3" rating for the Route 3 North lease revenue bonds. Both issues were removed from "Watchlist for possible downgrade". On November 26, 2003 the Governor signed a supplemental budget for FY04, which included an appropriation of $2.7 million for the facilities costs, including lease payments, associated with the College of Visual and Performing Arts at UMass Dartmouth. The FY05 GAA included $2.6 million in a specific item appropriation to fully fund this obligation.

13. NON-TAX REVENUE INITIATIVES

Chapter 653, Acts of 1989, amended Chapter 29 of the Massachusetts General Laws by adding Sections 29D and 29E, which authorize certain non-tax revenue initiatives and require reporting thereon, as follows.

A. *Debt Collection*

Pursuant to Massachusetts General Laws Chapter 29, Section D, Chapter 7A Section 8, allows private debt collection agencies to engage in debt collection for the Commonwealth. The fees paid are contingency based from the proceeds collected. Collections and fees paid during FY04 were:

Department Collectors	Collections	Fees
ACS State & Local Solutions	$ 1,270,142	$ 254,028
Allen Daniel Associates	249,864	46,060
Collection Company of America	2,316,948	512,782
Delta Management Associates, Inc.	571,965	143,940
Glenn Associates, Inc.	637,881	121,246
Gragil Associates, Inc.	97,302	21,404
NCO Financial Systems, Inc.	1,344	66
OSI Collection Services,, Inc.	1,359,989	266,953
Walker Associates Inc.	804,000	-
Windham Professionals, Inc.	1,403,012	717,070
Total	$ 8,712,447	$ 2,083,549

Under the same program, the following amounts were collected and fees paid for institutions of higher education: (These figures are a subset of the above).

Department Collectors	Collections	Fees
Allen Daniel Associates	$ 201,018	$ 36,692
Collection Company of America	1,338,358	292,603
Delta Management Associates, Inc.	570,169	143,583
Glenn Associates, Inc.	615,235	116,974
NCO Financial Systems, Inc.	1,344	69
OSI Collection Services, Inc.	438,348	88,070
Windham Professionals	188,277	43,644
Total	$ 3,352,749	$ 721,635

B. *Revenue Maximization*

Pursuant to Massachusetts General Law Chapter 29 Section 29E, contractors were engaged on a contingent fee basis to assist several of the Commonwealth's departments in the identification and collection of federal and other non-tax revenues. During FY04, $199,241,000 was generated through such efforts, of which $97,306,000 was credited back to the federal government. After contractor payments of $8,695,000, the Commonwealth received $93,240,000.

C. *Revenue Optimization*

The final year of authorization for the Revenue Optimization or "RevOpt" Campaign was in FY03. The RevOpt language allowed departments that are current MMARS users to engage in competitive procurements for expert services that will realize additional revenues for the Commonwealth. Payments made to vendors were contingent upon realized revenue and was made from the revenue generated from this effort. From inception through FY03, forty agencies proposed approximately 270 new projects, of which 66 projects generated over $254 million in gross optimized revenue, yielding over $223 million in net revenue to the General Fund.

D. *Cost Avoidance*

The Comptroller's appropriation authorizes contract arrangements engaged on a contingent fee basis for the purpose of identification and pursuit of cost saving/avoidance opportunities. During FY04, $160,016,000 of state expenditures were avoided, of which $80,008,000 would have been funded by the federal government. After contractor payments of $11,123,000, the Commonwealth had a net cost saving / avoidance of approximately $68,885,000.

E. *Intercept*

Intercept is authorized by M.G.L. Chapter 7A Section 3 and 815 CMR 9:06. Intercept is an automated process that offsets Commonwealth payments to delinquent receivables that have been approved by the Office of the State Comptroller. During FY04, the Intercept process was enhanced by using Web based technology to accept debt files from institutions of higher education. In FY04, the Commonwealth intercepted $5,195,000 of which $2,491,000 was on behalf of institutions of higher education.

F. *Telecommunication Audits*

Pursuant to Massachusetts General Law Chapter 29, Section 29E, authorized contractors were engaged on a contingent fee basis to provide telecommunication services audits to eligible entities of the Commonwealth. In FY03, five new contractors were added to this statewide contract to identify current or past billing overcharges and/or improper tariff rates and to negotiate a refund for overcharges with telecommunication companies on behalf of Commonwealth agencies. Telecommunication services audits could include, but are not limited to voice and data communication service recovery. The contract has exercised the second of two (1) year renewal options. There have been five authorized task orders from three different contractors to perform these services. In FY04, the contracts have not realized any refunds for the Commonwealth. Therefore, no payments have been made to the contractors to date.